

The infrastructure growth story

Will major infrastructure projects worldwide still offer good investment opportunities in a global downturn? Neal Underwood finds out.

Given the broad range of infrastructure funds available to European investors, naturally there are also many different approaches adopted. Some funds, for example, are heavily focused on opportunities in the developed markets. Others have a significant amount of the portfolio allocated to emerging markets, where growth rates are higher but political and economic risks tend to be greater.

Irrespective of geographical preferences, there are a number of overarching themes playing out in the infrastructure space at present. Peter Meany, manager of the First State Global Listed Infrastructure fund, says market volatility is the overriding theme right now. 'The theme that will impact infrastructure over the medium-term is slowing economic growth. However, as it slows around the world, the essential services that we invest in will continue to hold up well. We will see significantly less earnings downgrades than the broader market. Most of the businesses we invest in have got the history that could support 5% downgrades at worst. A lot are regulated or contracted, so in many cases volumes don't matter. They still earn a revenue regardless of volumes. In oil storage terminals and oil pipelines, clearly the demand will fall but the revenue streams are contracted for three to 15 years.' Ultimately, says Meany, at a company level, stock prices will do what they do in volatile markets, which will open up significant value in the sector.

Justin Lannen, portfolio manager of the CF Macquarie Global Infrastructure Securities fund, agrees. 'The question is how much GDP slows around the world and for how long. But this is traditionally a defensive asset class. We own assets that provide essential services, so we see relatively low demand risk in our sector. It's not cycli-

cal – so when the economy is very strong equally it tends not to race up.'

Another major theme, says Lannen, is the availability and pricing of credit. 'This has been a huge issue for all companies, not just specifically within infrastructure. We look for companies with sustainable business models, so the balance sheet is very important. We focus on companies we think are basically very credit worthy and have low amounts of refinancing. If we see some easing of the situation it will be positive for our fund.'

'We have seen debt rolled over and commercial paper issued in infrastructure,' says Meany. 'I can't see the banks not lending in the long term. It's clear that they will reduce risk, but if a regulated utility or toll road can't get finance then there are bigger issues for the rest of the economy. The terms of debt are not as attractive as in the past, but we certainly see a 0.5% increase in the cost of debt margins for infrastructure projects. They are getting back to where they were long-term. As governments have reduced interest rates, some of the more boring regulated assets have performed relatively well.'

Yet another theme highly relevant to infrastructure is the volatility of oil and gas prices. 'Two months ago this would have been very different from today given the economic slowdown,' says Lannen. 'On some of our assets it is an issue, such as toll roads and airports. But our experience is that historically when there's been an oil shock, the shock to the level of traffic tends to be relatively short lived. On toll roads, the medium to long-term trend tends to revert back to the mean.'

Inflation is also a consideration. An attraction of infrastructure stocks in a higher inflation environment is that they often



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have the ability to pass on inflation to users of their products. 'Inflation has ticked up quite a bit this year,' says Lannen. 'With regulated companies, higher inflation can be passed on to users. The problem for a lot of companies is they can't pass it on to customers, so they get margin compression.'

Meany, too, notes that infrastructure investments tend to be more robust in a high inflation environment. 'This is one of the things that differentiates infrastructure from other areas. Inflation is a significant dilution on real purchasing power. The companies we invest with have either such high barriers to entry that they can pass inflation on to their users, or are guaranteed in their concession agreement, for example toll roads. We will see toll road increases next year of 4%.'

One problem with the direct infrastructure market, as pension funds increase their allocations to the area and given what they are prepared to pay, has been that

sourcing the assets to meet that demand has been quite difficult, says Meany. 'We're seeing today an extraordinary amount of cash sitting in pension funds and direct infrastructure funds waiting for these opportunities. The decision is a very long-term one in nature. We've seen, for example, Chicago Midway Airport valued at 30 times EBITDA. There's a 30% to 50% valuation gap between listed prices and what unlisted funds are prepared to pay. I don't think this is sustainable. We will see listed stocks taken into private hands.'

Jonathan Schiessl, investment manager of the Ashburton Chindia Equity fund, says that six to eight months ago nearly 40% of his portfolio was in infrastructure investments, although this has since been reduced. Nevertheless, he expects China in particular to be a huge driver of infrastructure opportunities going forward. 'I expect more to come from China. They've still got so much to spend. It's a hell of a big country; by 2020

it will have a bigger highway network than the States, and the road system in China is all privately funded toll roads. One of the mantras in China at the moment is to move companies from the Eastern seaboard to the interior. The infrastructure to support this is simply not good enough. Transportation at present is predominantly by road, as rail links are still patchy.'

'The worry some people have now on the infrastructure side [in China] is there's not such an issue with financing, as there are huge government surpluses, but there is with spending at a local level,' says Schiessl. 'Property prices are falling off. Property developers are no longer buying land, and 30 to 50% of local government revenues come from land sales. In patches that could be true, but at the centre, national rail projects won't get stopped. Some of the second or third tier cities, if this gets out of hand, could be affected.'

One of the darlings of Chinese infrastructure investments has been a company

called China Communications Construction, says Schiessl. 'We made a fortune on it. But in its last results two months ago it totally surprised by market and came in with lower figures. We do have Chinese infrastructure investments. We're very focused on the railways, which have government central funding. Central government is very focused. They have to improve their infrastructure.'

An example of the pace at which Chinese infrastructure building is taking place can be seen in airports. In 1998 there were three Chinese airports handling over 10 million passengers a year. Today there are nine, and by 2018 this number is expected to rise to 30. 'In terms of distribution and logistics, there's such a long way for them to go,' says Schiessl.

He also notes that there are significant opportunities in India, where huge infrastructure projects are being tendered for in areas such as roads and power. But unlike China, India does have a problem with financing. 'It needs the private sector. We might see some slippage. The central government doesn't have the fiscal position that the Chinese government has.' Schiessl has cleared most of the exposure to Indian infrastructure from his fund as stocks had done too well. 'People were getting twitchy. Companies who were winning contracts were on very tight schedules. There were massive input cost rises and hence margin



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squeezes. There's also the issue that much of India's skilled labour force is in Dubai and other parts of the Middle East, so there were problems with manpower. They didn't have the skills. There's too much danger of project slippage or cancellation.'

That said, Schiessl says valuations have come back so far – they have almost halved in some cases – that he has started to look at opportunities in India once more.

'Pressure from input prices has fallen out of the equation. You can find good value.'

Meany, like Lannen, has some reservations about investing in emerging market infrastructure. 'Emerging market infrastructure stocks have been hit just as hard as the markets they sit in,' says Meany.

'We have seen a material deceleration of growth in emerging market infrastructure stocks, for example growth in Chinese ports has fallen from 25% last year to 15% this year. Infrastructure in emerging markets is still very much dependent more on export markets, rather than the decoupling theory which I never subscribed to anyway. Stocks have fallen significantly, by 30% to 60%, and earnings have not held up. A number of concerns that we raised about the inability to pass on inflation have come through, for example the Chinese government has stopped price increases on toll roads and airports. We clearly see long-term growth potential but we need more transparency and improved disclosure from companies.'

